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# OECD Countries: Growth, Inflation, and Current Account Outlook for 1978-79

An Intelligence Assessment

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*Central Intelligence Agency*
*National Foreign Assessment Center*

*July 1978*


## *Summary*

After substantial recovery in 1976, economic activity in most of the non-US OECD countries sagged again in 1977. The composite growth rate of the six largest countries—Japan, West Germany, France, United Kingdom, Canada, and Italy—dipped below 3 percent in 1977 and the smaller developed countries grew at less than 2 percent. Unemployment worsened, inflation remained high, and imbalances in international payments positions in the OECD were aggravated.

The outlook for 1978-79 is for slow but definite improvement in growth rates, marginal progress on unemployment, a decline in inflation rates in 1978 with possibly some rise in 1979, and a swing in the direction of a better balance of international payments deficits and surpluses. But the improvement is distinctly relative. The prospect in most of the OECD is for a continuation of higher rates of unused capacity, unemployment, and inflation than have been customary in the 1960s and early 1970s. Growth in the United States is forecast by the administration to slow down somewhat, but should still remain ahead of the OECD average.

Because the projected trends already seem fairly well established and the policies that underwrite them largely in place, we think our growth forecast is slightly more likely to err by being too low than by being too high. It does not differ drastically from forecasts made by outside sources, nor does our assessment of inflation prospects.


### Trends in GNP Growth

Real GNP growth in the non-US OECD is expected to reach 3 percent in 1978 and 3.5 percent in 1979, after attaining only 2.6 percent in 1977.[1] The smaller developed countries as a group are expected to experience a marginal drop in growth from 1.8 percent in 1977 to 1.6 percent in 1978 and a subsequent moderate recovery to 2.6 percent in 1979. The Big Six growth rate is forecast to climb from 2.9 percent in 1977 to 3.5 percent in 1978 and 3.9 percent in 1979 (see figure 1).

- In **Japan**, 1978 growth is projected to be 5.3 percent, considerably below the government's 7-percent target for fiscal year 1978. Expected growth in 1979 is placed slightly lower, at 5.1 percent. The driving force behind current Japanese growth is a 20-percent increase in budgeted government investment, raising projected 1978 total investment growth to 9 percent. Even if the

[1] Consistency and analytical requirements in the development of forecasts make it desirable to specify rates of change of the nearest tenth of a percent and current account balances to the nearest tenth of a billion dollars. However, since forecasting cannot really be that precise, small differences should be regarded as indicative rather than exact.

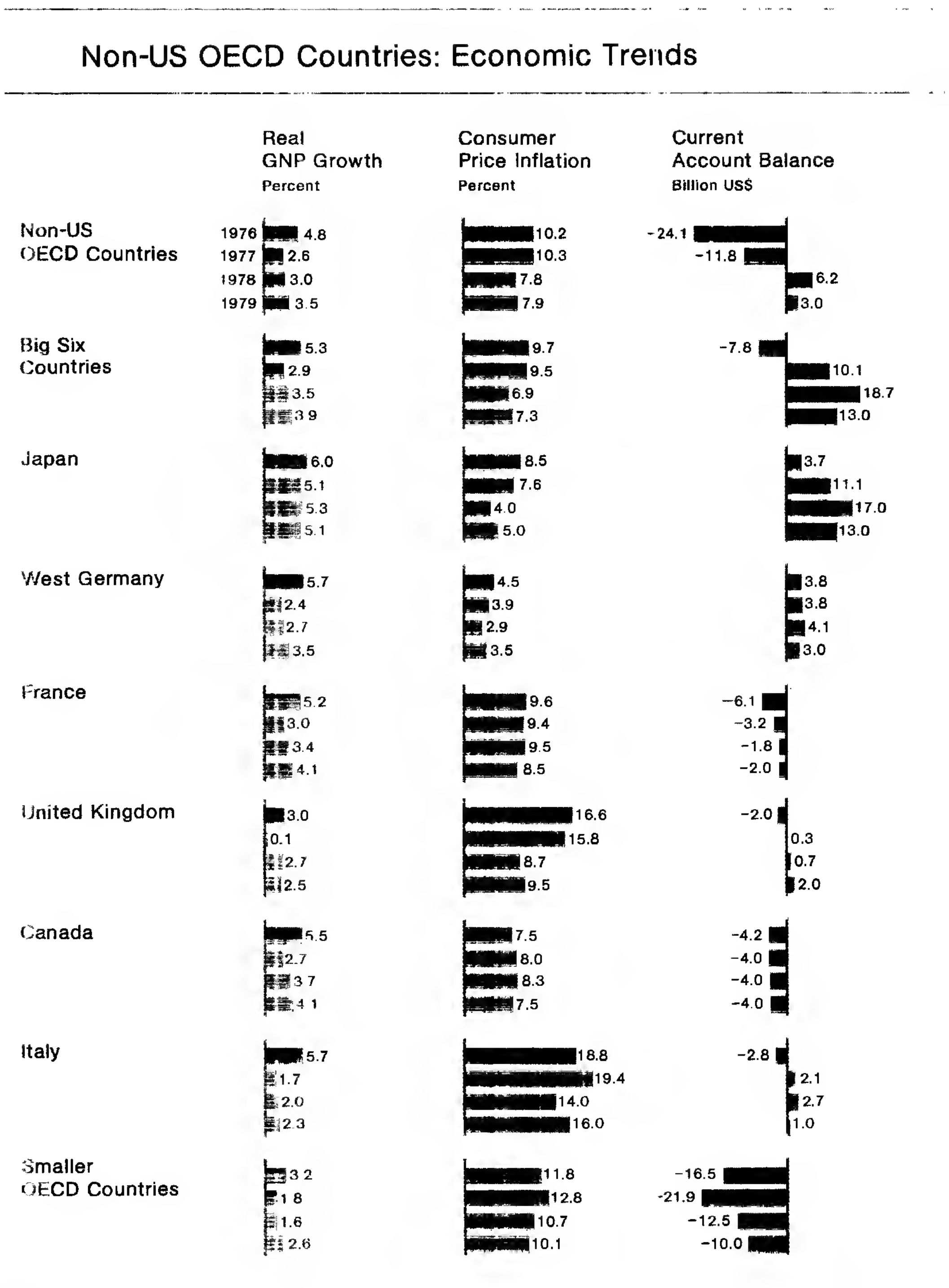
Non-US OECD Countries: Economic Trends
Real GNP Growth
Percent
Consumer Price Inflation
Percent
Current Account Balance
Billion US$
Non-US OECD Countries
1976
1977
1978
1979
4.8
2.6
3.0
3.5
10.2
10.3
7.8
7.9
-24.1
-11.8
6.2
3.0
Big Six Countries
5.3
2.9
3.5
3.9
9.7
9.5
6.9
7.3
-7.8
10.1
18.7
13.0
Japan
6.0
5.1
5.3
5.1
8.5
7.6
4.0
5.0
3.7
11.1
17.0
13.0
West Germany
5.7
2.4
2.7
3.5
4.5
3.9
2.9
3.5
3.8
3.8
4.1
3.0
France
5.2
3.0
3.4
4.1
9.6
9.4
9.5
8.5
-6.1
-3.2
-1.8
-2.0
United Kingdom
3.0
0.1
2.7
2.5
16.6
15.8
8.7
9.5
-2.0
0.3
0.7
2.0
Canada
5.5
2.7
3.7
4.1
7.5
8.0
8.3
7.5
-4.2
-4.0
-4.0
-4.0
Italy
5.7
1.7
2.0
2.3
18.8
19.4
14.0
16.0
-2.8
2.1
2.7
1.0
Smaller OECD Countries
3.2
1.8
1.6
2.6
11.8
12.8
10.7
10.1
-16.5
-21.9
-12.5
-10.0
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Figure I



 

government achieves its investment objective—if execution falls behind it may be necessary to pass supplementary budgets—consumption and business investment seem unlikely to respond sufficiently to push the economy to the 7-percent goal. Despite the seeming intractability of the Japanese payments surplus, measured in dollar terms, the growth of export volume is expected to slow, greatly lowering the direct contribution of the foreign sector to GNP growth and discouraging investment. Japan's strong showing in the first quarter of 1978 (10-percent GNP growth at an annual rate) is believed to be the result of temporary phenomena and a repetition of 1976 and 1977 patterns of rapid first-half growth. In 1979 the government would be unable to raise investment spending by another 20 percent, regardless of growth targets. Since we see some further strengthening of private spending in 1979, but no surge sufficient to take up all the slack in public investment, we expect growth in 1979 to fall off slightly from the 1978 rate.

- **West German** growth is projected at 2.7 percent in 1978 and 3.5 percent in 1979. A rise in government investment expenditures is pushing up total investment in 1978, as in Japan. Also as in Japan, recent currency appreciations are expected to constrain the growth of export volume, diminishing the impetus to growth from foreign demand. Lacking a surge in domestic private spending, which we do not foresee, German growth should pick up only moderately, unless the government undertakes a considerably more expansionary fiscal program than is currently on the books. This assessment does not take into account expansionary measures that Bonn may take as a result of the recent economic summit.

- In **France** GNP growth is forecast to rise from 3 percent in 1977 to 3.4 percent in 1978 and 4.1 percent in 1979. The return of the center-right coalition in the March parliamentary elections has restored business confidence, and investment growth is expected to rise from a −0.6 percent last year to 3 percent this year and 4 percent in 1979. Consumer spending is projected to pick up also, in response to rising incomes. Given France's still serious, although improving, inflation and balance-of-payments problems, the government is expected to concentrate on stabilization and avoid significant expansion in outlays.

- The **United Kingdom's** GNP, after virtually no growth in 1977, is expected to rise by 2.7 percent in 1978 and then fall off to 2.5 percent in 1979. Consumption is growing strongly, following recent tax cuts which bolstered disposable income. Business investment is rising also, in response to Britain's improved international payments position, an easing of government fiscal policy, and more buoyant consumer demand. But much of the increase in domestic demand is being satisfied by substantial increases in imports rather than contributing to the growth of domestic income. Further, sizable fiscal stimulus is not in the cards for 1979, given the government's likely reaction to an expected slow upward drift in inflation. Thus, with a slackening in the growth of disposable income, some possible restrictive fiscal policies, and a further tightening of monetary policy, growth of consumption and investment spending are both expected to subside, leading to the projected mild slowdown in 1979.

- In **Canada**, GNP is projected to grow at 3.7 percent in 1978 and 4.1 percent in 1979. The impetus for this growth is expected to come mainly from strengthening of consumer demand, further improvement in the net foreign balance, and inventory expansion. Private consumption is being spurred by temporary cuts in federal income and provincial sales taxes. The federal government, on the other hand, continues to follow a cautious policy with control of inflation its highest priority. Government consumption is therefore expected to hold near last year's 2 percent, rising only slightly higher in 1979. Investment spending continues to be extremely sluggish, although it should pick up on the strength of higher consumer demand, and could be favorably affected in 1979

if Ottawa moves ahead promptly with the Alcan pipeline.

- In **Italy**, GNP growth is forecast at 2 percent in 1978 and 2.3 percent in 1979. Political turmoil and economic uncertainty have sapped business confidence to a degree that investment is expected to be virtually stagnant in both 1978 and 1979. Domestic demand is expected to grow very slowly, and anticipated improvements in the real foreign balance will be needed to raise GNP growth even to the rates we are projecting. In spite of the government's rhetorical commitment to austerity, political agreement on required spending cuts has not been reached, and the 1978 budget deficit has been increasing rapidly. Unless this deficit is brought under control, our projections for government spending and probably consumption are likely to be under the mark. Thus, 1978 growth would be higher than forecast and so would imports; it is unclear how long the resulting international payments situation could be sustained.

### Unemployment and Inflation

Unemployment rates generally rose in 1977, and the diffident economic upturn forecast for 1978-79 is likely to do no more than slow the rise in unemployment in some countries and stabilize or marginally lower the unemployment rate in others. Among the Big Six, West Germany may record slight reductions in unemployment in 1978 and 1979. Joblessness should also decline in Britain in 1978 but is likely to rise again in 1979. Canada and France will probably see their unemployment rates worsen in 1978, while in 1979 the deterioration should at least be arrested. Japan may experience a marginal increase in unemployment in both years, but has fairly good medium-term unemployment prospects due to slower growth in the working-age population. The projected Italian growth rates in 1978 and 1979 foreshadow a continuing rise in unemployment. The smaller OECD countries are generally experiencing particularly rapid increases in unemployment, which should slow or come to a halt in 1979.

Inflation is expected to slow down in the non-US OECD from an average 10.3 percent in 1977 to 7.8 percent in 1978 and 7.9 percent in 1979. Weak demand and excess industrial capacity have been important factors in lowering inflation rates. Slack labor markets and past successes in slowing inflation have contributed to lowering wage settlements and reducing the cost-push element. Currency appreciations in a number of countries have also served to hold down the local currency prices of imports. These elements taken together have sufficient momentum in 1978 to lower inflation rates. However, the projected upturn in growth, as well as an assumed 10-percent nominal oil price increase next year, should arrest the current decline in 1979.

France and Canada are likely to witness an opposite pattern. In the case of France, the inflationary effects of current measures to reduce the scope of government price-setting should be felt principally in 1978. And in Canada, substantial increases in the domestic price of crude oil, the effects of significant currency depreciation, and a strong rise in food prices have all contributed to raising the inflation rate in 1978. None of these is expected to be as important in 1979.

### Current Account Balances

This Big Six combined current account surplus seems certain to grow substantially this year, from $10.1 billion to $18.7 billion. Concurrently, the enormous $21.9 billion deficit in 1977 of the smaller developed countries should drop to $12.5 billion, and the US deficit probably will rise by about $5 billion over its record 1977 level of $15.2 billion.[2] The steep increase in the Big Six surplus and sharp decline in the deficit of the smaller developed countries should lead to a swing in the non-US OECD current account balance from a $11.8 billion deficit in 1977 to a $6.2 billion surplus in 1978. This shift in the balance, despite the anticipated deterioration of the US balance,[3] should produce a decline in the total OECD deficit with the rest of the world from $27.0 billion to $14.2 billion.

[2] New definition: includes net reinvested earnings abroad.
[3] DRI forecast, adjusted to conform to new definition.

The outlook in 1979 is for a decline in the Big Six surplus, to $13.0 billion; continued reduction of the deficit of the smaller developed countries, to $10 billion; and improvement of the US deficit, bringing it down to $12.7 billion. As a result of the offsetting directions of movement in the Big Six and smaller developed country balances, the non-US OECD 1978 surplus of $6.2 billion is expected to decline to $3 billion. This decrease, in combination with the reduction of the US deficit,[4] implies a further drop in the total OECD deficit to $9.7 billion.

Two strands of consistency stand out: both the OECD as a whole and the smaller developed countries reduce their deficits in each of the forecast years. The first development is related to an anticipated sharp decline in the OPEC surplus owing to a drop in oil revenues in 1978 and an increase in the OPEC import bill. Volume and price factors each play a part on both the export and import side, with OPEC oil export volume down and price increasing less than world inflation rates, while import volume as well as prices are rising.

The intra-OECD swings in international balances between 1978 and 1979 are explained by the significant changes in currency values which have taken place over the past 18 months, as well as by the moderate convergence in growth rates within the OECD. The widely known "J-curve" effect—whereby currency depreciations temporarily cause larger deficits measured in value terms, and conversely appreciations cause temporary increases in surpluses (an inverted "J")—is exercising an important influence on the balances of some of the major countries, particularly Japan. Dollar prices of Japanese exports have risen considerably, while dollar prices of Japanese imports have remained relatively constant. Thus even though the Japanese foreign balance is forecast to remain constant in *volume terms* in 1978, its value in dollars is slated to reach $17 billion. Similar effects are in process in West Gemany and other countries with appreciating currencies. By 1979 a combination of the lagged effects on demand of the changed currency values, some reversal of import and export price movements, and the slowly converging US and non-US OECD growth rates are expected to make headway in reducing the prevailing intra-OECD imbalances.

[4] DRI forecast, adjusted to conform to new definition.

#### Uncertainties in the Forecast

Barring a further, major slowdown in US growth, we think there is relatively little downside risk in this forecast.

The base from which most countries are moving is low. The upward direction of movement is already generally clear. And the policy conditions necessary for the improvement are largely in place. Among the biggest countries, the projected Japanese growth rate depends on the government achieving its ambitious public investment target, and the Japanese commitment to this goal is quite strong. West German growth should be facilitated by an already ample growth of the money supply and by recent, moderate wage settlements. Balance-of-payments and inflation constraints have eased in most other countries, so that a sharp tightening of present demand management policies does not seem particularly likely. Our forecast assumption of a 10-percent increase in the nominal oil price in 1979 may be on the high side; and if so, the task of monetary authorities would be somewhat eased.

Inventory changes, one of the most volatile elements of the major GNP components, are a particularly vulnerable aspect of any forecast. In most cases where total final demand (which excludes stockbuilding) is rising, we have forecast increases in inventories. If these increases are not realized, actual output will e less than projected. In no country, however, is inventory change the major force in projected growth.

Prospective changes in the exchange rate are another area of uncertainty. It is conceivable that exchange markets could overcorrect and that countries with strongly appreciating currencies, such as Japan and West Germany, could experience significantly greater impact on their exports than we have forecast. It is also possible that the psychological effects of further currency changes, if they occur, could inhibit private spending. We have seen no convincing evidence

to date that these possibilities represent serious threats. In fact, there is some reason to believe that significant changes in currency values are increasingly being accepted by the private sector as a normal element in the conduct of business and absorbed smoothly into the flow of economic activity.

#### Comparison With Other Forecasts

This forecast does not differ greatly from others recently issued. With respect to real GNP, our expectation for 1978-79 growth in the Big Six economies is for higher growth than forecast by the OECD, about the same as that called for by Data Resources Incorporated, and lower than that predicted by Chase Econometrics (see appendix B). These other forecasters, as do we, also call for a general bottoming-out of the recent declines in these countries' inflation rates, and in some cases they project slight accelerations in inflation for next year.

## CONTENTS





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Table 1

OECD: Real GNP Growth

| | | | Percent Change From Previous Period | | | |
|---|---|---|---|---|---|---|
| | 1976 | 1977 | 2d Half 1976 [1] | 1st Half 1977 [1] | 2d Half 1977 [1] | 1st Half 1978 [1,2] |
| **OECD** | **5.4** | **3.6** | | | | |
| United States | 6.1 | 4.8 | 3.5 | 5.6 | 5.1 | 2.8 |
| Non-US OECD [3] | 4.8 | 2.6 | | | | |
| Big Six | 5.3 | 2.9 | 2.5 | 3.9 | 1.7 | 4.6 |
| Japan | 6.0 | 5.1 | 3.2 | 7.0 | 3.6 | 7.6 |
| West Germany | 5.7 | 2.4 | 2.9 | 3.1 | 1.2 | 3.0 |
| France | 5.2 | 3.0 | 2.0 | 4.3 | 1.3 | 4.7 |
| United Kingdom | 3.0 | 0.1 | 1.1 | −1.8 | 1.2 | 2.3 |
| Canada | 5.5 | 2.7 | 0.8 | 3.7 | 2.5 | 3.8 |
| Italy | 5.7 | 1.7 | 4.1 | 3.2 | −3.6 | 3.4 |
| Smaller OECD [3] | 3.2 | 1.8 | | | | |
| Spain | 1.9 | 2.5 | | | | |
| Netherlands | 4.0 | 2.5 | | | | |
| Australia | 3.5 | −0.2 | | | | |
| Belgium | 5.5 | 1.7 | | | | |
| Sweden | 1.2 | −2.5 | | | | |
| Switzerland | −2.1 | 4.0 | | | | |
| Austria | 5.2 | 3.5 | | | | |
| Turkey | 7.7 | 4.4 | | | | |
| Denmark | 5.0 | 1.0 | | | | |
| Norway | 5.7 | 4.3 | | | | |
| Finland | 0.4 | −0.7 | | | | |
| Greece | 6.0 | 4.0 | | | | |
| Portugal | 3.3 | 5.5 | | | | |
| New Zealand | −3.5 | −0.5 | | | | |
| Ireland | 2.6 | 5.1 | | | | |
| Luxembourg | 2.3 | 1.7 | | | | |
| Iceland | 1.9 | 4.2 | | | | |

[1] Seasonally adjusted at annual rate.
[2] Estimated.
[3] Because of data limitations for several countries, half-yearly rates were not calculated.

# OECD Countries: Growth, Inflation, and Current Account Outlook for 1978-79

## Recent Developments

### Trends in GNP

Real GNP in the six largest non-US OECD economies rose at an estimated annual rate of about 4.6 percent in first half 1978 (see table 1). This was an improvement over the extremely slow growth posted by these countries in the last half of 1977—only a 1.7-percent annual rate [1]—but still remained well below levels needed to substantially lower unemployment and reduce excess industrial capacity. Growth in the smaller industrial countries is generally lagging considerably behind that of the Bix Six.[2]

Among individual Big Six countries, which collectively account for 75 percent of the non-US OECD GNP, only Japan and France recorded creditable first-half growth performances. Most evidence suggests, moreover, that even these gains were largely due to special circumstances prevailing in early 1978 and may not be sustained.

- **Japan's** estimated real GNP growth of 7.6 percent in first half 1978 is by far the highest rate in the OECD, and above Tokyo's FY 1978 target of 7 percent. However, much of the growth was due to a probably temporary surge in exports and the impact in the first quarter of September and January supplementary budgets; since then, indicators suggest more moderate increases in real economic activity.
- **West Germany's** strong upturn in the fourth quarter of 1977 flattened early in 1978. Preliminary GNP figures for the first quarter indicate growth of only 1 percent, and industrial production in May was 3 percent below the January level. The beginning level of GNP in 1978, however, was sufficiently high to bring first-half growth to an estimated 3 percent.
- Next to Japan, **France** appears to have had the strongest first half among the Six. After hardly changing during last half 1977, French industrial output rebounded strongly throughout first quarter 1978, probably because business stopped running down inventories. Consumer spending picked up following the leftist defeat in the March parliamentary elections. Import volume increased as well in January-May, in response to rising demand. For the entire half, we estimate that France's real GNP growth was 4.7 percent.
- In the **United Kingdom**, real GNP rises seem to have remained sluggish despite the increasing net inflow of funds from North Sea oil sales. Real private consumption did move ahead strongly in the first half, up an estimated 6-percent rate over the second half of 1977, but much of this increase in demand spilled out of Britain into imports, holding GNP growth to only an estimated 2.3 percent rate.
- **Canada's** growth appears to have strengthened some in first half 1978, to an estimated 3.8 percent, compared with a 2.5-percent rate in last half 1977. As elsewhere, stagnant private investment demand continued to be the major retardant to more rapid expansion.
- The pace of economic activity in **Italy** seems to have accelerated strongly in early 1978,

[1] Throughout this paper half-yearly figures for rates of increase refer to seasonally adjusted changes over the preceding half, stated at an annual rate; see appendix A for the precise formula.

[2] In order of descending GNP, converted to US dollars at 1977 prices and exchange rates, the non-US OECD countries are: Japan, West Germany, France, the United Kingdom, Canada, Italy, Spain, Australia, the Netherlands, Sweden, Belgium, Switzerland, Austria, Turkey, Denmark, Norway, Finland, Greece, Portugal, New Zealand, Ireland, Luxembourg, and Iceland.

only to fall off again later in the first half. Industrial production, for instance, rose at an approximate 20-percent annual rate in first quarter 1978, but in April had dropped back to a level below that of the first quarter. For the entire first half, Italy's real GNP growth rate was an estimated 3.4 percent.

While detailed half-yearly data are not generally available on smaller OECD countries, it seems likely their growth in the first half of 1978 continued to be more sluggish than that of the Big Six. These countries as a rule did not rein in their economies to the extent the Big Six and the United States did in 1974-75; as a result, they incurred large current account deficits and were forced to adopt restrictive measures in 1976-77 that are still holding their economies back. For full-year 1977, they managed real growth of only 1.8 percent, compared with 2.8 percent for the Big Six and 4.8 percent for the United States.

### Unemployment

The rates of real economic growth recorded in the first half of 1978 in the non-US OECD countries, like the similar rates of the past two years, were not sufficient to reduce their jobless rolls significantly. In fact, in every Big Six economy except West Germany, we estimate that first half 1978 unemployment rates were higher than a year earlier, and in West Germany the rate dropped only 0.1 percentage point (see table 2). In the smaller countries, unemployment also has generally risen in response to these countries' very low GNP growth. In the five largest of the smaller countries—Spain, the Netherlands, Australia, Belgium, and Sweden—the increase in the number of unemployed this past March over that a year earlier ranged from 11 percent (Belgium) to 57 percent (Spain). In Spain, the number of registered unemployed reached 750,000 persons.

### Inflation

Because of the generally weak demand, slack labor markets, and excess industrial capacity, inflation rates in the OECD outside the United States continued their downward trend in first half 1978; still, some of the smaller countries saw their inflation accelerate. For the Big Six economies as a group, consumer price increases in the first half of 1978 dropped to a 5.2-percent rate, sharply lower than the pace in first half of 1977 (see table 3).

Individually, all Big Six countries recorded progress against inflation except Canada. Japan slashed its inflation rate the most, helped by slack demand, moderate wage increases and appreciation of the yen, which contributed to a 12-percent drop in import prices since early 1977. For the half year, Japan's rate of inflation

Table 2

Big Seven: Unemployment Rates

Percent

| | 1976 | 1977 | 2d Half 1976 [2] | 1st Half 1977 [2] | 2d Half 1977 [2] | 1st Half 1978 [2,3] |
|---|---|---|---|---|---|---|
| United States | 7.7 | 7.0 | 7.8 | 7.3 | 6.8 | 6.1 |
| Big Five [4] | 4.1 | 4.3 | 4.1 | 4.5 | 4.4 | 4.3 |
| Japan | 2.0 | 2.0 | 2.0 | 2.0 | 2.1 | 2.1 |
| West Germany | 4.6 | 4.5 | 4.5 | 4.5 | 4.6 | 4.4 |
| France | 4.3 | 4.9 | 4.3 | 4.7 | 5.1 | 4.8 |
| United Kingdom | 5.4 | 5.8 | 5.6 | 5.6 | 6.0 | 5.8 |
| Canada | 7.2 | 8.1 | 7.3 | 8.0 | 8.3 | 8.5 |

[1] Official unemployment rates; not comparable across countries.
[2] Seasonally-adjusted.
[3] Estimated.
[4] Italy excluded because of break in series.

probably will be about 2.5 percent, the lowest of any OECD country except Switzerland. West Germany cut its already low inflation rate even more, to an estimated rate of 2.7 percent for the first half.

Among the other Big Six countries, Britain and Italy both achieved significant progress. In Britain, the first-half rate of inflation is estimated to have been only about 6.3 percent, compared with 18.9 percent a year earlier; in Italy the first-half rate is put at 11.4 percent, compared with 21.4 percent a year ago. In both countries slack domestic demand has been a major factor in slowing inflation. Britain also was helped by a rise in the trade-weighted value of the pound. In France, consumer price inflation was cut to about an 8.2-percent rate, reversing the acceleration that occurred in the last half of 1977. In Canada, inflation—at a 9.4-percent rate—rose slightly over the rate recorded in the second half of 1977.

Among the smaller countries, the inflation record was quite varied, but in no smaller country did inflation appear to worsen substantially.

Table 3

OECD: Consumer Prices

Percent Change From Previous Period

| | 1976 | 1977 | 2d Half 1976 [1] | 1st Half 1977 [1] | 2d Half 1977 [1] | 1st Half 1978 [1,2] |
|---|---|---|---|---|---|---|
| **OECD** | 8.2 | 8.5 | | | | |
| United States | 5.7 | 6.5 | 5.3 | 7.4 | 5.9 | 7.7 |
| Non-US OECD [3] | 10.2 | 10.3 | | | | |
| Big Six | 9.7 | 9.5 | 9.4 | 9.9 | 7.5 | 5.2 |
| Japan [4] | 8.5 | 7.6 | 9.2 | 8.3 | 5.3 | 2.5 |
| West Germany | 4.5 | 3.9 | 3.5 | 4.4 | 3.3 | 2.7 |
| France | 9.6 | 9.4 | 10.0 | 8.9 | 10.2 | 8.2 |
| United Kingdom | 16.6 | 15.8 | 15.1 | 18.9 | 10.8 | 6.3 |
| Canada | 7.5 | 8.0 | 5.4 | 9.0 | 8.5 | 9.4 |
| Italy | 16.8 | 19.4 | 20.9 | 21.4 | 14.2 | 11.4 |
| Smaller OECD [3] | 11.8 | 12.8 | | | | |
| Spain | 17.6 | 24.5 | | | | |
| Netherlands | 8.8 | 6.5 | | | | |
| Australia | 13.5 | 12.3 | | | | |
| Belgium | 9.2 | 7.1 | | | | |
| Sweden | 10.3 | 11.5 | | | | |
| Switzerland | 1.7 | 1.3 | | | | |
| Austria | 7.3 | 5.5 | | | | |
| Turkey | 17.4 | 26.0 | | | | |
| Denmark | 9.0 | 11.1 | | | | |
| Norway | 9.1 | 9.1 | | | | |
| Finland | 14.4 | 13.1 | | | | |
| Greece | 13.3 | 12.1 | | | | |
| Portugal | 19.3 | 24.2 | | | | |
| New Zealand | 16.9 | 14.3 | | | | |
| Ireland | 18.0 | 13.6 | | | | |
| Luxembourg | 9.8 | 7.6 | | | | |
| Iceland | 33.0 | 30.0 | | | | |

[1] Seasonally adjusted at annual rates.
[2] Estimated.
[3] Because of data limitations for several countries, half-yearly rates were not calculated.
[4] Private consumption deflator.

Switzerland continued its position as the country with the lowest inflation in the OECD, recording only about a 1.3-percent annual rate of increase in the first half of 1978 over the last half of 1977. At the other extreme, Iceland's inflation rate continued in the 30-percent-a-year range. Spain, the Netherlands, and Finland were among the smaller countries that improved their inflation performances in the first half of 1978. For the group as a whole, the tentative first-half data available indicate a probable drop in smaller OECD country inflation of about a percentage point or so from the 12.8 percent rate of 1977.

### Current Accounts and Exchange Rates

The combined *current account balance* of the Big Six countries taken together improved considerably in the first half of 1978. From a combined annual-rate surplus of $17.2 billion in the last half of 1977, we estimate that these countries moved to a combined surplus of $22.3 billion at an annual rate in first half 1978 (see table 4). Much of the improvement was due to the rise in the Japanese surplus from an annual rate of $11.5 billion in last half 1977 to an estimated $19 billion annual rate in the first half

Table 4

OECD: Current Account Balances [1]

Billion US $

| | 1976 | 1977 | 2d Half 1976 [2] | 1st Half 1977 [2] | 2d Half 1977 [2] | 1st Half 1978 [2] [3] |
|---|---|---|---|---|---|---|
| **OECD** | **−19.8** | **−27.0** | | | | |
| United States | 4.3 | −15.2 | 1.4 | −10.6 | −19.6 | −24.0 |
| Non-US OECD [4] | −24.1 | −11.8 | | | | |
| Big Six | −7.6 | 10.1 | −13.5 | 2.8 | 17.2 | 22.3 |
| Japan | 3.7 | 11.1 | 2.0 | 10.6 | 11.5 | 19.0 |
| West Germany | 3.8 | 3.8 | 2.5 | 3.7 | 3.8 | 4.8 |
| France | −6.1 | −3.2 | −9.7 | −3.9 | −2.5 | −2.0 |
| United Kingdom | −2.0 | 0.3 | −2.8 | −3.0 | 3.6 | 0.4 |
| Canada | −4.2 | −4.0 | −3.6 | −4.5 | −3.5 | −3.1 |
| Italy | −2.8 | 2.1 | −1.9 | −0.1 | 4.3 | 3.2 |
| Smaller OECD [4] | −16.5 | −21.9 | | | | |
| Spain | −4.3 | −2.5 | | | | |
| Netherlands | 2.4 | 0.2 | | | | |
| Australia | −1.4 | −2.7 | | | | |
| Belgium-Luxembourg | −0.1 | −0.2 | | | | |
| Sweden | −2.4 | −3.3 | | | | |
| Switzerland | 3.5 | 3.5 | | | | |
| Austria | −1.5 | −3.0 | | | | |
| Turkey | −2.3 | −3.4 | | | | |
| Denmark | −1.9 | −1.6 | | | | |
| Norway | −3.8 | −5.0 | | | | |
| Finland | −1.2 | −0.2 | | | | |
| Greece | −1.0 | −1.3 | | | | |
| Portugal | −1.2 | −1.3 | | | | |
| New Zealand | −1.0 | −0.9 | | | | |
| Ireland | −0.3 | −0.2 | | | | |
| Iceland | 0.0 | 0.0 | | | | |

[1] Including goods, services, and transfer payments. The US balance is in accordance with the new definition, that is, including net reinvested earnings abroad.
[2] Seasonally adjusted at annual rates.
[3] Estimated.
[4] Because of data limitations for several countries, half-yearly rates were not calculated.

of 1978. At the same time, however, West Germany, France, and Canada also improved their current balance positions. Britain and Italy both incurred worsened current account balances in the first half, largely due to a surge in import volume in both countries, but both remained in surplus in their current accounts. Of the smaller countries, it appears that most held their own or improved their positions.

Movements in *exchange rates* for the first half of 1978 generally mirrored the current account balance trends. In part reflecting the relatively more favorable trends in the non-US countries' current balances, nearly all major foreign currencies strengthened against the US dollar (see figure 2). The Swiss franc rose the most, increasing in value against the dollar by 17 percent from November 1977 to June 1978; the Japanese yen followed closely with a rise of 14 percent. Of 15 major currencies, only the British pound, Canadian dollar, Italian lira, Australian dollar, Swedish kronor, and Norwegian kronor did not rise by 2 percent or more against the US dollar from November 1977 to June 1978.

Because the rise in other currencies against the US dollar was fairly general, shifts in *trade-weighted currency values* were not extreme as were changes in dollar exchange rates. The largest trade-weighted depreciation among the Big Six countries—about 4 percent—was recorded by Italy. The largest appreciation was by the Japanese yen, due to its strong rise against the dollar and the fact that much of Japan's trade is with the United States and Canada. The trade-weighted yen rose from November 1977 to June 1978 approximately 13 percent. Of the European countries, Switzerland had the largest trade-weighted appreciation—11 percent; Norway the largest trade-weighted depreciation—about 5 percent.

### Economic Policy in 1978

In response to slow real growth and high unemployment, and to the freedom provided by lower inflation rates and improved payments positions, some Big Six governments have shifted to more expansionary demand management stances than they held last year. Most of the smaller countries, however, continue to maintain relatively restrictive demand management policies.

Among the Big Six economies:

- **Japan's** economic policies have turned distinctly more expansionary over the course of the last year. Two supplementary budgets were implemented in fiscal 1977—which ended on 31 March of this year—and the fiscal 1978 budget projects a deficit equal to 5.5 percent of GNP. In addition, while Tokyo is holding back on further stimulus in the hope that strong first-quarter growth will continue, Prime Minister Fukuda is committed to his growth target and would be willing to launch additional stimulus—probably in the form of new deficit spending—if it appears needed. Growth of the money supply, on the other hand, slowed somewhat during the last half of the fiscal year.
- **West Germany's** economic policies have turned slightly more expansionary this year. In response to last year's demand weakness, the government adopted additional expansionary measures last September, with much of the impact falling this year. Consequently, the public sector deficit will probably increase in 1978 by as much as 50 percent over 1977, in sharp contrast to the contractions experienced in 1977 and 1976. Monetary policy has also become easier, with the Bundesbank's 8-percent target for year-on-year growth of the central bank money stock almost certain to be exceeded by 2 to 3 percentage points.
- **France** continues to believe that economic stabilization is the appropriate policy for its economy. Accordingly, the budget deficit and the growth of the money stock probably both will be slightly reduced this year. Any additional policy initiatives likely will follow Giscard's new theme of improving France's economic efficiency, boosting private investment, and reducing the government's economic role.
- In the **United Kingdom**, the fiscal policy stance has relaxed markedly since the begin-



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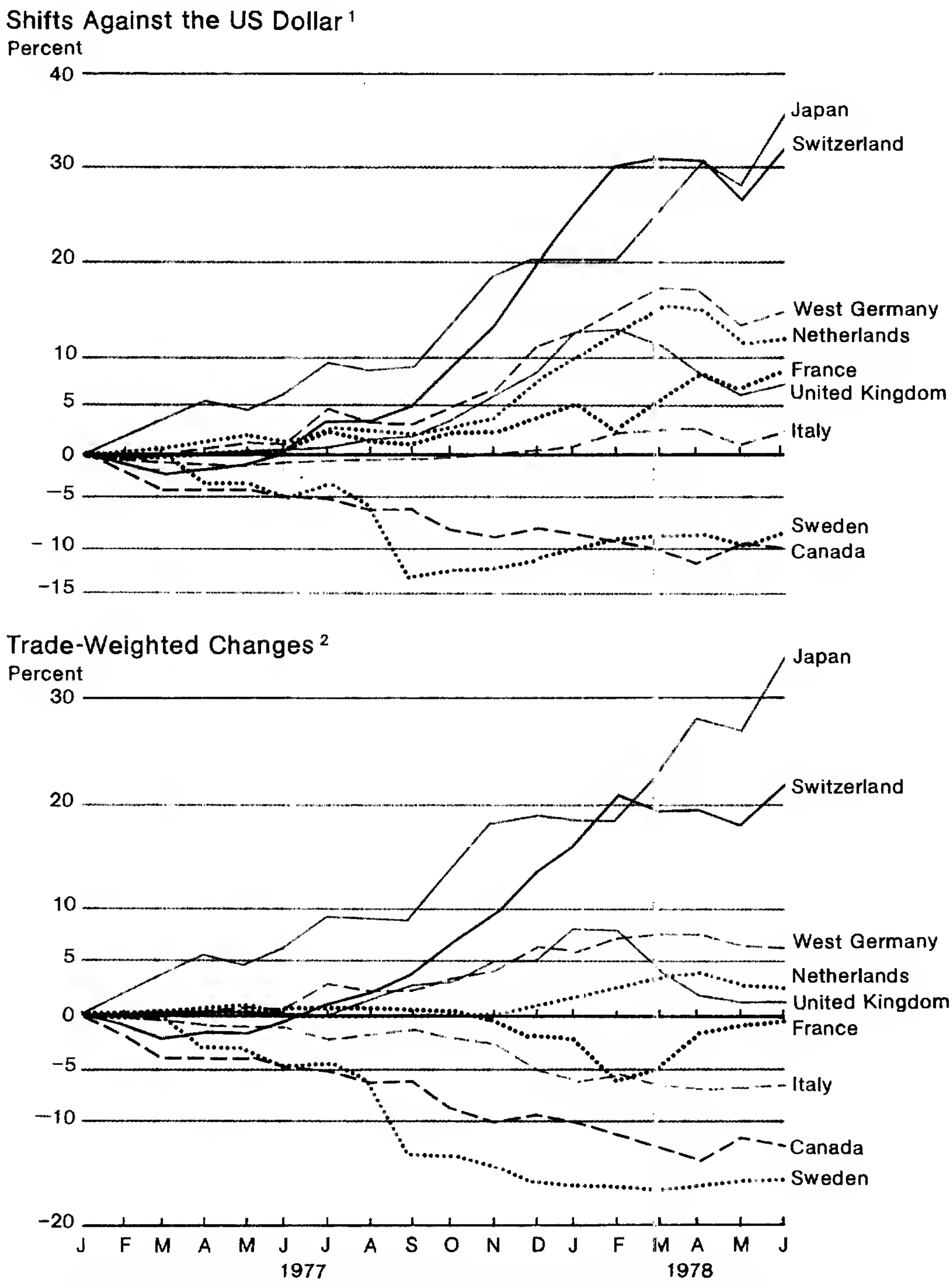
## Selected Foreign Currencies: Exchange Rate Fluctuations




1 Percent chenge in US cents per foreign currency unit from Jenuery 1977 to month indiceted.

2 Percent chenge in bileterel-trede-weighted value of currency from Jenuary 1977 to month indicated.

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Figure 2



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ning of 1978. The 1978/79 budget provided for substantial personal income tax relief with the result that the public sector borrowing requirement is expected to rise to $15.5 billion, just short of the limit London promised the IMF as a borrowing condition.

- In **Canada,** policy probably remains more oriented toward reducing inflation than in any other Big Six country. Provincial authorities—responding to federal urging—are cutting some taxes to provide a modest economic boost, but because of Canada's high inflation, and budget and balance-of-payment constraints, the Federal Government is unlikely to risk any additional stimulus.
- More from neglect than design, **Italy** probably is following an expansionary fiscal policy. While both the minority Christian Democrat government and its Communist backers remain verbally committed to austerity, the parties have been unable to agree on the spending cuts necessary to curb a runaway public budget deficit. As a result, preliminary figures for early 1978 showed a deficit in the federal government budget twice as large as in 1977. With fiscal policy in this disarray, the Bank of Italy is attempting to maintain stability—without causing excessive credit stringency—by keeping a fairly tight rein on the money supply.

### The Smaller OECD Countries

Most of the 17 smaller OECD countries, responding to their generally higher inflation and payments deficits than experienced by the Big Six, are following demand management policies that range from neutral to restrictive. Several of these countries have been following this course since policies were instituted to slow the inflation explosion of four years ago. Most notable of this group is Switzerland, which instituted severe restraint to wring out inflation, and despite having succeeded in lowering inflation to a 1-percent rate and obtaining a $4 billion current account surplus, continues a fiscal policy that is, at most, neutral. Other countries have recently shifted, willingly or unwillingly, to more restrictive policies. Spain, for example, after seeing its current account deficit rise to $4.3 billion in 1976, instituted restrictive policies last year and is continuing them into 1978 in an attempt to further reduce the deficit and lower inflation. Portugal and Turkey both were forced to apply severely restrictive policies to obtain needed foreign credits from the IMF. Demand management policies probably are most expansionary in the Netherlands, Ireland, and Belgium.

### The Outlook for 1978

Based on first-half performance and current demand management policies, non-US OECD real growth for 1978 seems likely to improve over 1977, but still remain generally sluggish and continue to fall behind the pace of US growth (see table 5). This moderate increase in the rate of expansion abroad, combined with a mild slowdown in US growth, is expected to produce

Table 5

Non-US OECD Countries: Real GNP Growth

Percent

| | 1977 | 1978 [1] |
|---|---|---|
| Non-US OECD | 2.6 | 3.1 |
| Big Six | 2.9 | 3.5 |
| Japan | 5.1 | 5.3 |
| West Germany | 2.4 | 2.7 |
| France | 3.0 | 3.4 |
| United Kingdom | 0.1 | 2.7 |
| Canada | 2.7 | 3.7 |
| Italy | 1.7 | 2.0 |
| Smaller OECD | 1.8 | 1.6 |
| Spain | 2.5 | 0.5 |
| Netherlands | 2.5 | 2.7 |
| Australia | −0.2 | 1.0 |
| Belgium | 1.7 | 2.5 |
| Sweden | −2.5 | 0.8 |
| Switzerland | 4.0 | 1.7 |
| Austria | 3.5 | 1.5 |
| Turkey | 4.4 | 0.0 |
| Denmark | 1.0 | 1.2 |
| Norway | 4.3 | 4.2 |
| Finland | −0.7 | 0.7 |
| Greece | 4.0 | 5.0 |
| Portugal | 5.5 | 2.5 |
| New Zealand | −0.5 | −1.5 |
| Ireland | 5.1 | 5.7 |
| Luxembourg | 1.7 | 2.5 |
| Iceland | 4.2 | 4.0 |

[1] Projected.

relatively flat growth for the OECD as a whole. With growth in the Big Six to be up from 2.9 percent in 1977 to 3.5 percent this year, continued slow growth of the smaller OECD countries of about 1.6 percent, and US growth in the 4-percent range, overall OECD growth is projected to about duplicate the mediocre 3.6-percent rate achieved in 1977. The somewhat better balance among countries is welcome, but it will still leave OECD members outside the United States with high levels of excess capacity and unemployment. Moreover, improvement in growth of the Big Six is heavily influenced by a rapid increase of government investment spending in Japan and Germany, which may be difficult to maintain, while private investment is expected to continue to lag in both countries.

In contrast to 1977, when domestic demand in the Big Six grew more slowly than GNP, growth of the domestic components of GNP is expected to exceed GNP growth slightly in 1978 (see table 6).

- Bolstered by lower inflation rates in much of the Big Six and greater government stimulus in some, **private consumption** is expected to grow more rapidly than in 1977 in each country except Italy. This acceleration in consumption spending is most pronounced in the United Kingdom, from −0.8 percent decline in 1977 to 4 percent in 1978, while in the rest of the group consumption is expected barely to keep pace with the expansion of domestic demand.
- **Public consumption** will also grow at a more rapid rate than in 1977, with France and Japan continuing to have the highest rate of increase. Only in Italy is current government spending expected to expand more slowly than in 1977, and this only slightly. Nonetheless, public consumption does not occupy a leading role in raising Big Six GNP growth, since in the majority of countries, including France and Japan it does little

Table 6

Big Six: Composition of Real GNP Growth[1]

Percent

| | GNP | | Private Consumption | | Government Consumption | | Gross Fixed Investment | | Final Domestic Demand | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1977 | 1978 | 1977 | 1978 | 1977 | 1978 | 1977 | 1978 | 1977 | 1978 |
| Big Six | 2.8 | 3.5 | 2.3 | 3.2 | 1.8 | 2.8 | 1.7 | 5.1 | 2.1 | 3.6 |
| Japan | 5.1 | 5.3 | 3.2 | 3.6 | 3.6 | 3.6 | 4.3 | 9.0 | 3.7 | 5.4 |
| West Germany | 2.4 | 2.7 | 2.9 | 3.1 | 0.7 | 3.1 | 3.0 | 4.2 | 2.5 | 3.4 |
| France | 3.0 | 3.4 | 2.5 | 2.8 | 3.8 | 3.5 | −0.6 | 3.0 | 1.9 | 3.0 |
| United Kingdom | 0.1 | 2.7 | −0.8 | 4.0 | −0.2 | 2.0 | −3.9 | 4.5 | −1.2 | 3.7 |
| Canada | 2.7 | 3.7 | 2.8 | 3.2 | 2.0 | 2.0 | 0.3 | 0.8 | 2.2 | 2.5 |
| Italy | 1.7 | 2.0 | 2.1 | 2.1 | 2.3 | 2.2 | 0.1 | 0.0 | 1.8 | 1.7 |

| | Export of Goods and Services | | Imports of Goods and Services | | Net Foreign Demand[2] | | Total Final Demand | | Changes in Inventories[2] | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1977 | 1978 | 1977 | 1978 | 1977 | 1978 | 1977 | 1978 | 1977 | 1978 |
| Big Six | 6.6 | 4.4 | 2.4 | 4.9 | 1.0 | 0.1 | 3.0 | 3.5 | −0.2 | 0.1 |
| Japan | 10.4 | 3.5 | 2.0 | 5.0 | 1.5 | 0.0 | 5.0 | 5.1 | 0.2 | 0.2 |
| West Germany | 4.1 | 4.5 | 4.2 | 6.2 | 0.1 | −0.3 | 2.6 | 2.9 | −0.1 | −0.2 |
| France | 6.3 | 5.1 | 1.0 | 5.0 | 1.1 | 0.1 | 3.0 | 3.0 | 0.1 | 0.5 |
| United Kingdom | 6.0 | 4.4 | 3.8 | 5.9 | 0.7 | −0.3 | −0.5 | 3.3 | 0.6 | −0.6 |
| Canada | 7.4 | 4.4 | 2.5 | 1.9 | 1.0 | 0.5 | 3.2 | 3.1 | −0.8 | 0.6 |
| Italy | 5.8 | 4.5 | −1.0 | 4.0 | 1.6 | 0.3 | 3.3 | 1.9 | −1.6 | 0.1 |

[1] Components may not aggregate to totals because of rounding.
[2] Change in component as percent of GNP in previous year.

more than keep up with growth of domestic demand.

- **Investment** spending, expected to rise 5.1 percent, is clearly the growth leader for the Big Six as a whole. Even so, this rate is sluggish by historical standards. Moreover, the picture in individual countries is quite mixed. Investment is not expected to grow at all in Italy and very little in Canada, while French investment should recover from a −0.6 growth last year to a modest 3 percent. In Japan and West Germany, which account for 52 percent of Big Six GNP, investment spending is expected to climb by 9 percent and 4.2 percent respectively. But the principal reason for these higher rates of expansion is a deliberately adopted policy of economic stimulation through higher government investment, which is producing exceptionally high public deficits in both countries; private investment is expected to remain sluggish. Only in the United Kingdom will a high investment growth rate of 4.5 percent reflect a resurgence of business investment spending.

- **Inventory changes** are expected to contribute slightly to growth in 1978, after exercising a mildly contractionary influence in 1977. Stockbuilding will speed growth significantly in Canada and France, and only in the United Kingdom will inventory increases be smaller than last year.

Big Six export volume is expected to slow down to about 4.4 percent this year, while import volume growth should pick up to 4.9 percent. As a result, no growth in Big Six real *net foreign demand* is expected, in contrast to last year when it contributed 1 percent to Big Six GNP growth. Individual countries will fare differently, however, with net foreign demand pulling down GNP growth substantially in the United Kingdom, and in West Germany. In contrast, Canada and Italy should see GNP growth boosted as a result of contributions from net foreign demand.

This zero growth in the Big Six foreign balance, when measured in volume terms, translates into a formidable increase in dollar value. This occurs because of a substantial rise in export prices (relative to import prices) brought about by currency appreciations; because exports exceed imports by a considerable margin and therefore even the same percentage increases in export and import prices would raise the absolute value of the surplus; and because the appreciations themselves result in a higher dollar figure even for a constant foreign currency figure. The Six's current account position—defined as goods, services, and all transfers—is projected to rise from \$10.1 billion in 1977 to \$18.7 billion in 1978, principally on the strength of an anticipated increase in the Japanese balance of about \$6 billion (see table 7). A growing British surplus

Table 7

Non-US OECD: Consumer Price Inflation and Current Account Balances

| | Consumer Price Inflation (Percent Changes Over Previous Year) | | Current Account Balance (Billion US \$) | |
|---|---|---|---|---|
| | 1977 | 1978 | 1977 | 1978 |
| Non-US OECD | 10.3 | 7.8 | −11.8 | 6.2 |
| Big Six | 9.5 | 6.9 | 10.1 | 18.7 |
| Japan [1] | 7.6 | 4.0 | 11.1 | 17.0 |
| West Germany | 3.9 | 2.9 | 3.8 | 4.1 |
| France | 9.4 | 9.5 | −3.2 | −1.8 |
| United Kingdom | 15.8 | 8.7 | 0.3 | 0.7 |
| Canada | 8.0 | 8.3 | −4.0 | −4.0 |
| Italy | 19.4 | 14.0 | 2.1 | 2.7 |
| Smaller OECD | 12.8 | 10.7 | −21.9 | −12.5 |
| Spain | 24.5 | 17.0 | −2.5 | −1.5 |
| Netherlands | 6.5 | 4.7 | 0.2 | 2.1 |
| Australia | 12.3 | 8.0 | −2.7 | −3.2 |
| Belgium | 7.1 | 7.0 | −0.2 [2] | 0.5 [2] |
| Sweden | 11.5 | 9.5 | −3.3 | −3.0 |
| Switzerland | 1.3 | 1.3 | 3.5 | 4.0 |
| Austria | 5.5 | 4.0 | −3.0 | −2.9 |
| Turkey | 26.0 | 30.0 | −3.4 | −1.5 |
| Denmark | 11.1 | 11.0 | −1.6 | −1.5 |
| Norway | 9.1 | 9.1 | −5.0 | −4.0 |
| Finland | 13.1 | 8.5 | −0.2 | 0.3 |
| Greece | 12.1 | 13.0 | −1.3 | −1.6 |
| Portugal | 24.2 | 26.0 | −1.3 | −1.2 |
| New Zealand | 14.3 | 14.0 | −0.9 | −0.9 |
| Ireland | 13.6 | 8.7 | −0.2 | −0.5 |
| Luxembourg | 7.6 | 7.8 | — | — |
| Iceland | 30.0 | 30.0 | 0 | 0 |

[1] Private consumption deflator.
[2] Including Luxembourg.

and a shrinking French deficit, both owing to higher export prices, will also contribute to this result. As a group, the smaller OECD members should see their enormous $21.9 billion deficit in 1977 decline to about $12.5 billion. Thus the non-US OECD current account balance should swing from a $11.8 billion deficit in 1977 to a $6.2 billion surplus in 1978.

In a marked departure from last year's pattern, when improvement in the non-US OECD current account balance and deterioration in the US balance were largely offsetting, the US deficit should rise moderately in 1978 and the OECD as a whole should therefore register a strong net gain in its current account position. With the anticipated increase in the US deficit at about $5 billion, the $18 billion favorable swing in the non-US OECD balance will mean a roughly $13 billion improvement in the total OECD position. OPEC more than fully accounts for the corresponding decline in surpluses outside the OECD. With the price of oil constant, export volume down, and both import prices and volume rising, the OPEC 1978 surplus is expected to fall to $17 billion from its $34 billion 1977 level. The non-OPEC LDC current account deficit is projected to rise $4 billion to $5 billion over last year's $22 billion, while Communist countries as a group are expected to continue to run an approximately $11 billion deficit.[3]

Even though the pace of growth outside the United States should pick up, most other OECD countries can expect *inflation* rates to continue to decline in 1978. For the OECD as a whole, consumer prices should rise 7.3 percent down 1.5 percentage points from last year's increase. Slower growth in wages, in turn partially related to earlier progress in reducing inflation, has been an important factor. A number of countries, most notably West Germany and Japan, have been helped by declining import prices resulting from exchange appreciation. The United Kingdom and Italy have also contributed importantly to reducing the Big Six inflation rate, expected to decline to 6.9 percent in 1978 from last year's 9.5-percent level. However, British nominal wages are likely to rise in 1978 at a more rapid rate than last year, which could pose a threat to continued success of the government's anti-inflation program. In most of the smaller developed countries the rate of price increase is expected to be constant or falling moderately, with the average for the group projected to decline from 12.8 percent to 10.7 percent.

Based on the growth rates expected in the non-US OECD countries, it seems probable that their *unemployment* situation will not improve much this year over 1977. Indeed, some worsening may occur as 1978 progresses, if the growth of labor productivity—which has recently been quite slow—accelerates some. Among the Big Six, expectations are for slight declines in unemployment in West Germany, and Britain, and slight increases in France, Canada, Japan, and Italy (see table 8).

**Table 8**

**Big Six: Unemployment Rates [1]**

Percent

| | 1977 | 1978 |
|---|---|---|
| Japan | 2.0 | 2.1 |
| West Germany | 4.5 | 4.3 |
| France | 4.9 | 5.1 |
| United Kingdom | 5.8 | 5.6 |
| Canada | 8.1 | 8.4 |

[1] Excludes Italy because of break in series.

## Economic Prospects in 1979

### Trends in GNP

The 1979 outlook is for another year which would be judged poor by the standards of the 1960s and early 1970s, but which shows further improvement compared to the slump of 1977 and this year's slow and hesitant recovery (see table 9).

Our assumptions are that:

- US growth, at 4.3 percent, will roughly match that projected for 1978, and the US current account balance will experience a distinct turnaround, both in real and current dollar terms.

[3] Because of statistical discrepancies, it is not possible to exactly reconcile world current account balances and changes.

- The OPEC oil price will rise, but the increase will be held to a nominal 10 percent.
- World food and commodity prices will not register significant real increases.

Under these assumptions it seems plausible that the Big Six might raise their average growth to 3.9 percent, the smaller developed countries as a group might gain another percentage point in growth, reaching 2.6 percent, and the average OECD GNP increase might therefore climb to 3.8 percent, with no improvement and perhaps a slight worsening in the overall inflation rate. Looking at the country breakdown, the picture is of course mixed, both with respect to prospects and the likelihood of the projected outcome.

- In **Japan** the government is putting steam into the economy through a 20-percent increase in the government investment budget for FY 1978, which began 1 April. Japanese officials hope that this will impart sufficient momentum to economic activity to achieve the 7-percent FY 1978 growth target set by Prime Minister Fukuda and to continue expansion through 1979, without the need for further extraordinary government stimulus. Our assessment is that excess capacity will not be reduced sufficiently to set off the needed private investment boom, and that regardless of intentions, the government would be unable to duplicate the current rate of growth in its investment budget in 1979. Thus we see 1979 growth hovering slightly above 5 percent. Although low Japanese inflation should soften the impact on export sales of yen appreciation, a significant drop in the Japanese current balance, in dollar terms, is expected in 1979.
- In **West Germany**, the prospect is for a moderately expansionary 1979 government budget; not taking account of additional stimulation measures Chancellor Schmidt

Table 9

Big Six: Composition of Real GNP Growth

Percent

| | GNP | | | Private Consumption | | | Government Consumption | | | Gross Fixed Investment | | | Final Domestic Demand | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1977 | 1978 | 1979 | 1977 | 1978 | 1979 | 1977 | 1978 | 1979 | 1977 | 1978 | 1979 | 1977 | 1978 | 1979 |
| **Big Six** | **2.9** | **3.5** | **3.9** | **2.3** | **3.2** | **3.4** | **1.8** | **2.8** | **2.9** | **1.7** | **5.1** | **4.3** | **2.1** | **3.6** | **3.6** |
| Japan | 5.1 | 5.3 | 5.1 | 3.2 | 3.6 | 3.9 | 3.6 | 3.6 | 4.0 | 4.3 | 9.0 | 6.0 | 3.7 | 5.4 | 4.7 |
| West Germany | 2.4 | 2.7 | 3.5 | 2.9 | 3.1 | 3.6 | 0.7 | 3.1 | 3.0 | 3.0 | 4.2 | 4.0 | 2.5 | 3.4 | 3.6 |
| France | 3.0 | 3.4 | 4.1 | 2.5 | 2.8 | 3.8 | 3.8 | 3.5 | 3.5 | −0.6 | 3.0 | 4.0 | 2.0 | 3.0 | 3.8 |
| United Kingdom | 0.1 | 2.7 | 2.5 | −0.8 | 4.0 | 2.5 | −0.2 | 2.0 | 2.0 | −3.9 | 4.5 | 3.5 | −1.2 | 3.7 | 2.6 |
| Canada | 2.7 | 3.7 | 4.1 | 2.8 | 3.2 | 3.9 | 2.0 | 2.0 | 2.5 | 0.3 | 0.8 | 1.8 | 2.2 | 2.5 | 3.2 |
| Italy | 1.7 | 2.0 | 2.3 | 2.1 | 2.1 | 2.1 | 2.3 | 2.2 | 2.4 | 0.1 | Negl | 1.0 | 1.8 | 1.7 | 2.0 |

| | Exports of Goods and Services | | | Imports of Goods and Services | | | Net Foreign Demand [1] | | | Total Final Demand | | | Changes in Inventories [1] | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1977 | 1978 | 1979 | 1977 | 1978 | 1979 | 1977 | 1978 | 1979 | 1977 | 1978 | 1979 | 1977 | 1978 | 1979 |
| **Big Six** | **6.6** | **4.4** | **5.0** | **2.4** | **4.9** | **5.2** | **1.0** | **Negl** | **0.1** | **3.0** | **3.5** | **3.6** | **−0.1** | **0.1** | **0.3** |
| Japan | 10.4 | 3.5 | 7.0 | 2.0 | 5.0 | 8.0 | 1.5 | Negl | 0.3 | 5.0 | 5.1 | 4.7 | 0.2 | 0.2 | 0.5 |
| West Germany | 4.1 | 4.5 | 5.2 | 4.2 | 6.2 | 6.0 | 0.1 | −0.3 | −0.1 | 2.6 | 2.9 | 3.4 | −0.1 | −0.2 | 0.1 |
| France | 6.3 | 5.1 | 5.0 | 1.0 | 5.0 | 5.0 | 1.1 | 0.1 | 0.1 | 3.0 | 3.0 | 3.8 | 0.1 | 0.5 | 0.4 |
| United Kingdom | 6.0 | 4.4 | 3.7 | 3.8 | 5.9 | 4.1 | 0.7 | −0.3 | 0 | −0.5 | 3.3 | 2.5 | 0.6 | −0.6 | 0 |
| Canada | 7.4 | 4.4 | 4.0 | 2.5 | 1.9 | 2.9 | 1.0 | 0.5 | 0.2 | 3.2 | 3.1 | 3.5 | −0.8 | 0.6 | 0.6 |
| Italy | 5.8 | 4.5 | 4.0 | −1.0 | 4.0 | 3.8 | 1.6 | 0.3 | 0.2 | 3.3 | 1.9 | 2.2 | −1.6 | 0.1 | 0.1 |

[1] Change in component as percent of GNP in previous year.

may undertake as a result of the economic summit. Official German unemployment, while continuing high, is ameliorated by substantial unemployment benefits, illegal moonlighting, and smaller families, which make possible higher participation rates in the labor force. Also, deeply rooted German antipathy toward inflation will continue to constrain deficit spending by the Federal Republic. Under these circumstances the expectation is for a further rise in the German growth rate to 3.5 percent in 1979. This should result from greater consumer spending, spurred both by the low inflation rate and additions to real disposable income conferred by improvement in the West German terms of trade, and from investment spending which continues to rise at a rate slightly ahead of GNP growth. The Federal Republic's current account balance in dollars is expected to fall in 1979 and real net foreign demand to shrink slightly. Nevertheless, as in the case of Japan, the low German inflation rate is expected to shield exports against excessive damage from currency appreciation, although profit margins will probably be squeezed.

- In **France** the recent defeat of the left in parliamentary elections serves to fix the broad lines of economic policy for several years to come. Monetary and fiscal measures will continue to be aimed at reducing inflation and strengthening the slowly improving French current account balance. The brighter 1978 picture, following the uncertainty and erosion of confidence during the preelection period, should provide the foundation for further expansion of both consumption and investment spending in 1979. As a result, growth of domestic demand is expected to rise to 3.8 percent, while additional impetus from net foreign demand and stockbuilding should pull GNP growth marginally beyond 4 percent.

- In the **United Kingdom**, GNP is expected to grow only 2.5 percent, somewhat under the forecast for 1978. The current surge of consumer spending, buoyed by recent tax cuts, seems likely to be temporary. Imports are growing substantially, with the growth of domestic income therefore falling behind the growth in domestic demand. And by early next year we expect the effects of the tax cuts to be fully absorbed, thus halting the recent rapid rise in real disposable income. Further actions by London to prop up consumer spending seems unlikely. With the advent of a new round of wage-bargaining and intermittent downward pressure on the pound, the government is increasingly apprehensive over inflation and is more likely to tighten fiscal and monetary policies than to relax them further. Weakening consumer demand coupled with higher interest rates should begin to dampen this year's mini-investment boom by early 1979. Recent surveys of intended investment spending have already begun to show a softening in projected business spending.

- The economic picture in **Italy** is particularly volatile. The unsettled political situation is sapping investor and consumer confidence, and as a consequence we expect slow growth in domestic demand. This, in turn, should result in GNP growth only a little better than this year's projected 2 percent and a continued, but nevertheless smaller, current account surplus. However, deficit spending by the government is sharply increasing at the present time, creating the potential for a burst of demand in late 1978 or early 1979. If demand did surge in this manner, Italian GNP growth and inflation in 1979 would probably exceed our projection and the current account surplus would shrink further.

- In **Canada**, GNP growth will probably strengthen next year to around 4 percent. Most of the gain will come from increased consumption and a small rebound in investment. Unlike this year, the foreign sector will add only little to real growth. Full termination of wage and price controls at the end of this year is expected to increase wage gains at a time when consumer price inflation should be easing and employment growing. The resulting boost in real household

income will help strengthen consumption growth. Investment gains are also expected, if Ottawa decides to move ahead with the Alcan pipeline and begins letting contracts by late 1978. Machinery and equipment investment should begin to pick up as retooling begins for the pipeline. Residential construction should also begin to recover as this year's glut of new homes is worked off. Despite some convergence in the rates, export growth is expected to continue to exceed import growth.

### Unemployment

In light of the only moderate acceleration in growth projected for the Big Six in 1979, it seems unlikely that much progress will be made in shortening jobless rolls in these countries. Japan, where the growth of the working-age population is slowing due to a drop in the number of persons turning 18, has perhaps the best hope of reducing unemployment. In the European countries, increases in the working-age population growth will make reductions in unemployment more difficult, while in Canada, expectations of continued increases in participation rates dim prospects for lowering unemployment. Given the projected 1 percentage point increase in GNP growth of the smaller countries, their unemployment rates should rise more slowly or remain constant.

### Inflation

Inflation rates in 1979 in the OECD outside the United States probably will cease to improve as they did in 1975-78 (see table 10). West German inflation seems to have stabilized at about 3 percent and seems unlikely to go much lower. Japan, Italy, and Britain could experience some acceleration in their inflation next year: in Japan this could occur if the yen rises less than in 1978; and in Britain higher inflation seems likely as a result of strengthening wage demands by workers who are attempting to recoup real wage losses of 1975-77. A possible 10 percent or so rise in nominal oil prices in 1979, after an 18-month freeze, also will contribute to halting the decline in inflation rates.

### International Payments

It is in the international payments area that 1979 appears to hold the most promise for improvements. Due to relatively strong non-OECD demand growth and likely continued slow growth in OECD demand for imported oil, it seems probable that the OECD deficit with the

Table 10

Non-US OECD Countries: Consumer Price Inflation and Current Account Balances [1]

| | | Consumer Price Inflation (Percent) | Current Account Balance (Billion US $) |
|---|---|---|---|
| Non-US OECD | | | |
| | 1977 | 10.3 | −11.8 |
| | 1978 | 7.8 | 6.2 |
| | 1979 | 7.9 | 3.0 |
| Big Six | | | |
| | 1977 | 9.5 | 10.1 |
| | 1978 | 6.9 | 18.7 |
| | 1979 | 7.3 | 13.0 |
| Japan | | | |
| | 1977 | 7.6 | 11.1 |
| | 1978 | 4.0 | 17.0 |
| | 1979 | 5.0 | 13.0 |
| West Germany | | | |
| | 1977 | 3.9 | 3.8 |
| | 1978 | 2.9 | 4.1 |
| | 1979 | 3.5 | 3.0 |
| France | | | |
| | 1977 | 9.4 | −3.2 |
| | 1978 | 9.5 | −1.8 |
| | 1979 | 8.5 | −2.0 |
| United Kingdom | | | |
| | 1977 | 15.8 | 0.3 |
| | 1978 | 8.7 | 0.7 |
| | 1979 | 9.5 | 2.0 |
| Canada | | | |
| | 1977 | 8.0 | − 4.0 |
| | 1978 | 8.3 | − 4.0 |
| | 1979 | 7.5 | − 4.0 |
| Italy | | | |
| | 1977 | 19.4 | 2.1 |
| | 1978 | 14.0 | 2.7 |
| | 1979 | 16.0 | 1.0 |
| Smaller OECD | | | |
| | 1977 | 12.8 | −21.9 |
| | 1978 | 10.7 | −12.5 |
| | 1979 | 10.1 | −10.0 |

[1] Data for 1978 and 1979 are projected.

world will decline to about $10 billion in 1979, compared with the $14.2 billion forecast for 1978. Moreover, given more rapid growth in OECD surplus countries relative to OECD deficit countries, and continuing adjustment in response to 1978 shifts in the exchange rate, it also seems likely that the internal distribution of OECD surpluses and deficits will improve next year. In particular, the Japanese surplus is likely to decline, although still remaining above $10 billion, and the West German surplus also should fall. Britain's surplus, however, will increase slightly because of rising North Sea oil exports. In the smaller OECD deficit countries, an improvement in their deficits probably will occur, but likely not of the magnitude that occurred in 1978.

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# APPENDIX A

## Methodology

The forecasts of economic developments in foreign developed countries presented in this report are based primarily on judgments of country experts. The judgments are derived from detailed analysis of indicators of economic activity, examination of other assessments, and extrapolation of recent trends and changes in trends.

Growth rates are calculated using average-period rather than end-of-period data. For full-year growth rates the formula used is:

$$((\text{Value in given year}/\text{Value in preceding year})-1) \times 100.$$

For half-year growth rates the formula used is:

$$((\text{Value in given half-year}/\text{Value in preceding year})^2-1) \times 100.$$

All half-year data presented in the paper have been adjusted for seasonal variation.

All forecasts are checked for internal and external consistency. These checks help uncover potential conflicts within the forecasts and increase the logical accuracy of the projections. They do not, of course, prevent forecast error resulting from inaccurate exogenous assumptions.

For the larger developed countries a number of checks are performed on major GNP components. Values for the forecast period are compared to historical trends over the past 15 years. The check includes analysis of:

### Private Consumption Expenditure

- The implied values of the marginal and average propensities to consume out of total GNP.
- The implied values of the marginal and average propensities to consume and save out of real disposable income. Household income is derived from independent estimates of wage rates, consumer prices, employment, and hours worked. The consistency of these series is in turn cross-checked by viewing what they imply for employment-output ratios and productivity trends.

### Gross Fixed Domestic Investment

- The ratio between investment and GNP as well as the trend pattern for each.

**Imports**

- The implied values of the marginal and average propensity to import.
- The relationship between domestic and import prices. Import prices are checked—against a trade share matrix—to ensure consistency with both the world rate of inflation and likely currency realignments.

**Exports**

- The implied change in real nominal trade shares. To help ensure consistency between export growth and import growth of trading partners, potential export gains are also derived assuming constant historical trade shares.
- The competitive position and changes in competitive position vis-a-vis major trading partners.
- The consistency between changes in export prices and domestic prices.

In smaller developed countries internal consistency is checked by viewing the relationship between GNP growth and changes in domestic demand. External consistency is provided by checks similar to those used for the larger countries.

The consistency check procedure is an iterative process. Preliminary projections supplied by country experts form the basis of the first consistency round. The results are used to modify both domestic and international income and price components for individual countries. Revised forecasts are then prepared. These are used in the second consistency round during which most remaining major inconsistencies are resolved. Further iterations are carried out if needed for specific countries.

# APPENDIX B

## Big Seven: Forecasts of Real GNP Growth

Percent Change

| | CIA [1] | OECD [2] | DRI [3] | Chase-Econometrics [4] |
|---|---|---|---|---|
| | | | 1978 | |
| Big Seven [5] | 3.8 | 3.6 | 3.9 | 3.7 |
| United States | 4.0 | 3.9 | 4.0 | 3.4 |
| Big Six [5] | 3.6 | 3.4 | 3.9 | 4.1 |
| Japan | 5.3 | 4.5 | 5.4 | 6.0 |
| West Germany | 2.7 | 2.8 | 3.0 | 3.0 |
| France | 3.4 | 3.3 | 3.4 | 3.8 |
| United Kingdom | 2.7 | 2.6 | 2.9 | 2.7 |
| Canada | 3.7 | 4.0 | 4.4 | 3.9 |
| Italy | 2.0 | 1.5 | 3.0 | 2.9 |
| | | | 1979 | |
| Big Seven [5] | 4.1 | 3.4 | 3.8 | 3.8 |
| United States | 4.3 | 3.3 | 3.6 | 3.0 |
| Big Six [5] | 3.9 | 3.5 | 4.0 | 4.5 |
| Japan | 5.1 | 4.5 | 5.2 | 5.6 |
| West Germany | 3.5 | 3.1 | 3.5 | 3.9 |
| France | 4.1 | 3.7 | 3.7 | 4.7 |
| United Kingdom | 2.5 | 2.0 | 2.6 | 4.0 |
| Canada | 4.1 | 3.5 | 4.3 | 4.1 |
| Italy | 2.3 | 3.0 | 3.8 | 3.3 |

[1] US projections are administration forecasts.

[2] Preliminary May 1978 projections. 1979 figures are projections for the first half of the year.

[3] Projections for Germany and the UK are from the July interim European forecast, France and Italy are from the June *European Outlook*, Canada is from the June *Canadian Review*, Japan is from the June *Japanese Economic Review*.

[4] May projections.

[5] For comparability 1976 GNP weights were used. These may differ slightly from the moving year weights used.

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